February 2021

WHAT WE'RE WATCHING

INFLATION

Inflation is being watched closely by markets and investors keen to understand if it will accelerate in response to massive fiscal and monetary stimulus that looks set to continue even as economies recover.

The US is in focus given that the new Democrat Administration campaigned on big spending programs to address a number of policy issues. Markets are questioning whether the US economy will overheat, leading to higher inflation and higher interest rates which would ultimately undermine share prices.

The other key factor that drives inflation is the state of the labour market. Currently, the unemployment rate in Australia and the US is still above pre-COVID-19 levels. Our analysis indicates it may be some time before pre-pandemic levels are seen again.

We should note however, that headline inflation will likely spike up between now and the middle of the year as some of the base effects of the abnormally weak inflation a year ago wash out of the calculations. This may excite fixed-income investors at the time, but the statistical effect will be temporary and will not represent a sustained increase in inflation. Central banks are likely to not be concerned by it.

Here in Australia, the Reserve Bank of Australia (RBA) has commented that the labour market is unlikely to be strong enough to deliver meaningful wage increases for a few years. Nor are we likely to see big fiscal spending programs as might happen in the US, so the upside risks here are likely to be less than in the US.

SUMMARY

It is reasonable for the US bond market to be wondering about the risks of higher inflation given the possible spending programs the Democrats might introduce. However, there are still considerable uncertainties about the size and timing of such programs while the economy still has a relatively high unemployment rate. In Australia, the risks are lower and the RBA’s outlook for inflation around 1.25% - 1.75% seems reasonable. As such, we foresee higher inflation as a risk for 2022 not 2021.

WHAT WE'RE WATCHING

CURRENCY

The three main drivers of the A$/US$ exchange rate are currently the Australia/US bond yield differential, the iron ore price and the US$ Trade Weighted Index (a measure of US currency strength compared to a basket of US trading partners). We discuss each one below.

The bond differential between Australia and the US, is sitting close to zero and the currency is in line with what the differentials suggest. This comes after an extended period through last year when COVID-19 pushed the Australian Dollar well below levels implied by the differentials. In effect, our dollar has returned to equilibrium with the differentials. The RBA has made it clear that its program of buying long-dated bonds is designed to limit the appreciation of the A$. We believe the RBA will try to keep the bond differential with the US as close to zero as they can, or lower, if possible. This means the differentials may be a relatively neutral factor for our dollar this year.

As one of our major exports, the price of iron ore is a key driver of the A$/US$. The iron ore price has run ahead of the A$/US$ exchange rate since late last year.

Iron ore has slipped back a bit recently, but at its current levels still suggests the A$/US$ is undervalued and should be closer to US$0.80. However, futures markets are pricing a steady decline in the iron ore price through 2021 from US$160/MT to US$122/MT by the end of the year. That is a 27% decline, with most of the fall in price happening in the second half of the year. This would suggest our currency may also depreciate towards the end of the year.

The US$ Trade Weighted Index (TWI) has been weaker recently as markets take account of more expansionary fiscal policy under the Democrats, combined with a soft monetary policy stance from the Fed. Markets are also considering the risk of higher US inflation as a result of these stimulatory policies. Higher inflation relative to the rest of the world can lead to currency depreciation to even out the relative prices.

As a result, markets currently expect the US dollar to continue depreciating through 2021, implying that our currency may appreciate against the US dollar.

SUMMARY

Putting these, at times, conflicting currency signals together, we get a profile in which the A$/US$ exchange rate continues to appreciate towards the middle of the year, rising over US$0.80 and potentially as high as US$0.85. Then, in the second half of the year, the A$/US$ exchange rate slips back towards US$0.80.

WHAT WE'RE WATCHING

SPEED AND SUCCESS OF THE COVID-19 VACCINE ROLLOUT

The speed of the rollout of the COVID-19 vaccine and its success in preventing infections is another key factor for markets.

Delays and shortages in vaccine deliveries, slow uptake and the discovery of new variants of COVID-19 could derail markets' confidence.

Various factors have already shown that a number of governments will miss their initial vaccination targets.

These factors range from shortages of vaccine doses to health authorities struggling to organise mass vaccinations quickly and the IT constraints involved in monitoring and logging vaccine recipient data.

While there will still be a focus on infections rates, we expect vaccination rates to be by the most important barometer of equity market sentiment in 2021.

PORTFOLIO POSITIONING

Given these evolving factors, we have positioned portfolios with an average amount of exposure to growth strategies, such as shares, while tilting this exposure to sectors that present better value. We will continue to monitor these closely and make any adjustments as needed.